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SUBJECT: Taiwan Survey Shows Deeper Economic Integration

11. Summary: Taiwan's Chinese National Federation of Industries (CNFI) latest survey of Taiwan investors in China suggests the scale of investment in the PRC is rising. Investors are increasingly focused on the domestic Mainland China market. The highest policy priority for firms surveyed is direct cross-Strait transportation links. End summary.

12. The Chinese National Federation of Industries, one of Taiwan's largest business associations, released its latest survey of members with investment in China. The survey addresses the investment climate in Mainland China and offers policy recommendations to the Taiwan authorities. This is the tenth year CNFI has conducted the annual survey. CNFI sent questionnaires to 2,000 firms with investments in the PRC and received 304 replies between November 15 and December 10, 2006.

13. Key characteristics of the 304 firms surveyed include:

-- Investment Scale. The number of firms with large-scale investment in the PRC was substantially higher than last year. Firms with total investment valued at more than US\$20 million in the 2006 survey accounted for 16.2 percent, compared to just 4.7 percent in 2005. Firms with investment under US\$5 million accounted for 61.6 percent, down from 64.8 percent in 2005. Firms with investment between US\$5 and 10 million made up 12.5 percent, down from 20.8 percent in 2005; and investments between US\$10 and 20 million accounted for 9.8 percent of firms, virtually the same as the 9.7 percent in 2005.

-- Ownership Structure. A higher percentage of firms surveyed had wholly-owned affiliates in the PRC at 79.2 percent in 2006 compared to 52.8 percent in 2005 and 71.8 percent 2004.

-- Industry. Non-high technology manufacturing industries accounted for 71.7 percent of firms surveyed; including rubber and plastics (17.8 percent), textiles and garments (11.9 percent), food and beverages (11.2 percent), and basic metals (6.9 percent). High technology manufacturing accounted for 21.1 percent, including electronics and electrical appliance manufacturing (12.5 percent) and machinery and instrument manufacturing (8.6 percent). Services accounted for 7.2 percent; including retail and wholesale trade (4.9 percent), finance and insurance (1.3 percent), and science and technology services (1 percent). Industry percentages were little changed from the previous year.

14. Survey results on local economic conditions in Mainland China include the following:

-- Increasingly Focused on PRC Market. The firms surveyed indicated that the domestic Chinese market accounted for 61.5 percent of total sales in 2006 up from 56.7 percent a year earlier. The proportion of export sales back to Taiwan also rose from 5.4 percent in 2005 to 7.4 percent last year. Export sales to other areas dropped to 31.1 percent in 2006 from 32.1 percent in 2005.

-- Strong Local Competition. Taiwan firms see Mainland local producers as their strongest competitors for the local market. Among the firms surveyed, 74.1 percent identified PRC enterprises as their main competitors. Other major competitors included Hong Kong (identified by 15.5 percent of respondents), South Korean (15.2 percent), U.S. (11.1 percent), and Japanese firms (10.8 percent).

-- RMB Appreciation Not a Hindrance. More than 85 percent of respondents to the survey expect the renminbi to appreciate against major international currencies in 2007. The firms were asked how appreciation would affect the cost of raw materials, their export performance, domestic sales, and investment plans. To each question a large majority of firms said appreciation of the renminbi would have a positive effect or no effect at all.

15. Survey findings on cross-Straits economic policies include the following:

-- Direct Transportation Will Increase Investment in PRC. More respondents indicated that they would increase their investment in China than in Taiwan if direct transportation links are implemented. Of respondents, 45.9 percent said they would increase investment in the PRC, while only 23.2 percent said they would increase investment in Taiwan. However, an even smaller percentage, just 11.3 percent, said they would reduce investment in Taiwan after direct links. A large majority, 65.6 percent, said that direct links would have no

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effect on plans to invest in Taiwan.

-- Policy Recommendations Have Changed. As in 2005, implementing "three links" was the cross-Straits policy suggestion supported by the highest percentage of respondents (75.7 percent in 2006 compared to 77.0 percent the previous year). However, other priorities changed substantially. The second highest priority was a cross-Straits investment protection agreement, supported by 47.7 percent of respondents. Such an agreement was just the ninth highest priority in 2005, supported by only 26.6 percent. The third highest priority in 2006 was the establishment of official offices to assist in the resolution of commercial disputes. The recommendation was supported by 46.1 percent. In 2005, it was the eighth highest priority supported by 27.5 percent. The second and third highest priorities in 2005 were regularizing cross-Straits charter flights and the establishment of schools in the PRC for children of Taiwan investors. These fell to the fifth and ninth highest priorities, respectively. The significant drop in support for these recommendations may be due in part to progress made in these areas during the last year.

16. Comment: The annual CNFI survey is a useful opportunity to take the pulse of Taiwan's investors in the PRC. This year's survey shows that some of the same trends of previous years continue. Rising scales of investment, more wholly-owned subsidiaries, increasing focus on the domestic PRC market, and other trends demonstrate that cross-Straits economic integration continues to deepen.